Office of Chief Counsel
Internal Revenue Service

memorandum

CC:SER:KYT:NAS:TL-N-1856-99
HPLevine, ID# 62-09574

date: 9/17/99

to: Chief, Examination Division, Kentucky-Tennessee District
Attention: Karen Blair

from: District Counsel, Kentucky-Tennessee District, Nashville

subject: [redacted]
Deductibility of IPO costs other than attorney and accountant ees

DISCLOSURE STATEMENT

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This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

ISSUE:

Whether [redacted] can deduct expenses other than attorney and accountant's fees incurred in connection with the sale and leaseback of property and IPO of a REIT?

CONCLUSION:

[redacted] cannot deduct expenses paid or incurred in connection with the sale and transfer of properties in the sale and leaseback. Rather, they should be capitalized and amortized over the period of the future benefits.

FACTS AND DISCUSSION:

This is to supplement the April 13, 1999 memorandum and July 16, 1999 Field Service Advice (FSA), which both concluded that attorney and accountant fees incurred in connection with the sale and leaseback and REIT IPO must be capitalized. The remaining expenses are broken up into title recording fees, privilege taxes for the sale and transfer of properties and other costs associated with the sale as reflected in the list attached to your August 27, 1999 memorandum.

For the same reasons expressed in the April 13, 1999 memorandum and July 16, 1999 FSA, the taxpayer must capitalize all expenditures incurred in the sale and transfer of the properties. The basic premises of the analysis supporting capitalization are that: (1) capitalization take precedence over a current deduction as an ordinary and necessary expense; (2) an expenditure is capital if it provides the taxpayer with a significant future benefit; and (3) the sale-leaseback in connection with the REIT IPO provided the taxpayer with significant benefits in future years. Therefore, the expenditures must be capitalized.

Although the privilege taxes are in some respects different than the other expenses, they are also subject to capitalization under the same principles. Taxes are separately deductible under I.R.C. § 164 and not allowed solely as an ordinary and business expense under I.R.C. § 162. However, they are subject to the same capitalization rules. See I.R.C. § 195, which provides that start-up expenditures do not include any amount to which a deduction is allowed under I.R.C. § 164. That taxes were specifically excluded from the definition of a start-up expense reflects that they would otherwise have been included.

I.R.C. § 164 governs the allowance of taxes. Under the flush language of I.R.C. § 164, any tax paid or accrued in connection with the disposition of property shall be treated as a reduction in the amount realized on the disposition. The determinative issue is therefore whether the taxes were paid or incurred in connection with the disposition of property.

Under I.R.C. § 164, the taxes are allowed to reduce the amount realized if they were paid or incurred ***in connection*** with the disposition of the property. Two cases shed light on this determination. In Hustead v. Commissioner, T.C. Memo. 1997-205, the taxpayer claimed deductions for State and local property taxes on undeveloped land which he had rezoned to enhance the value of the property. The court held that the obligation to pay the taxes arose out of mere ownership of the undeveloped land, and not out of the rezoning activities, and therefore they were deductible under I.R.C. § 164(a). In Sleiman v. Commissioner, T.C. Memo. 1997-530, aff'd 84 AFTR2d ¶ 99-5264 (11th Cir. 1999), the court considered whether taxes were incurred in connection with purchasing property, in which event they were required to be treated as part of the cost of acquiring the property, or in connection with obtaining construction loans, in which event they could be amortized over the life of the loans. The court found that they were "more closely incurred in connection with obtaining the construction loans than in acquiring the real properties."

In this case, the privilege taxes for the sale and transfer of properties were paid or incurred because of the sale and transfer of the properties from [redacted] and [redacted] to the REIT. However, the sale was part of an integrated transaction, whereby: (1) a present and future funding source was created; and (2) [redacted] sold and leased the [redacted] facilities from the REIT, both of which were intended to provide [redacted] with significant future benefits. Consequently, we believe that the taxes were paid in connection with the sale-leaseback transaction and not solely in connection with the disposition of the property and therefore, the taxes should also be capitalized and amortized over the period of the future benefits.

We are seeking post-review from our National Office because of the technical nature of this issue. In the interim, we suggest that you prepare in draft the proposed adjustment with the included additional grounds for disallowance in order to better facilitate discussion with the taxpayer and its representatives.

Attached is a client survey which we request that you consider completing. The client survey is an attempt to measure your satisfaction with the service provided by this office. We expect to be able to use your response to improve the services that we provide to you. Please contact the undersigned at (615) 250-5072 if you have any questions.

JAMES E. KEETON, JR.
District Counsel

By: /s/ H P Levine
HOWARD P. LEVINE
Senior Attorney

Attachment:
Client survey

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:SER:KYT:NAS:TL-N-1856-99
HPLevine, ID# 62-09574

date: APR 13 1999

to: Chief, Examination Division, Kentucky-Tennessee District
Attention: Karen Blair

from: District Counsel, Kentucky-Tennessee District, Nashville

subject: [redacted]
Deductibility of REIT IPO costs

DISCLOSURE STATEMENT

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ISSUE:

1. Whether [redacted] can deduct attorney and accountant's fees incurred in connection with the IPO of a REIT?

CONCLUSION:

1. Whether [redacted] can deduct attorney and accountant's fees incurred in connection with the IPO of a REIT depends on whether the fees were a sales expense or part of a corporate reorganization, created a new asset or provided future benefits.

FACTS AND DISCUSSION:

[redacted] went through a substantial restructuring in [redacted]. It intended to sell and lease back [redacted] of its [redacted] facilities. It consummated the transaction by transferring the [redacted] (together with those owned by a subsidiary, [redacted]) to [redacted] in I.R.C. § 351 transactions on [redacted]. The assets were sold on [redacted], by [redacted] to a REIT which was formed on [redacted]. The REIT was funded through the IPO, which took place on [redacted]. The [redacted] board chairman was also the trust chairman for the REIT. The [redacted] were leased by the REIT to [redacted] pursuant to [redacted] to [redacted] year leases with options for [redacted] additional [redacted]-year periods. The REIT also had options to purchase and lease back additional [redacted]. Between the date of the IPO and year-end [redacted], the REIT purchased from and leased back [redacted] additional facilities to [redacted]. The sales price paid to [redacted] was from funds raised in the IPO. [redacted] was required to be a co-registrant on Form S-3 for the IPO. The REIT later issued preferred stock for which [redacted] was also required to be a co-registrant. The proceeds were used to repay indebtedness incurred as a result of the REIT purchasing additional facilities from [redacted] in [redacted] and [redacted].

[redacted] claimed and deducted $[redacted] in attorney fees and $[redacted] in accountant fees that it incurred in connection with the REIT IPO. It claims that these fees were incurred as a sales expense. [redacted] also claims that these fees were not required to be capitalized since stock of the REIT and not their own was issued. [redacted] disclosed in the Form 10-K that the relationship with the REIT was expected to provide access to additional capital to fund future growth. The REIT purchased the [redacted] stock for $[redacted] in [redacted], and merged the [redacted] operations into its own.

Nature of the Inquiry:

Whether the attorney and accountants fees that were expended in connection with the IPO (hereinafter IPO fees) can be used to reduce the sales price depends on whether the costs were associated with the sale or as part of a capital restructuring or transaction which created a separate asset or some future benefit. The inquiry is fact dependent and requires a pragmatic approach. [redacted] transferred the assets to [redacted] on [redacted], and they were sold to the REIT on [redacted]. The Form 10-K implies that the relationship with the REIT was created to provide access to additional capital for future growth.

The main issue in this case is determining why the IPO fees were incurred. In this regard, if the fees were more in the nature of costs incurred to sell the assets, then it may be proper to offset them against the amount realized in the sale. This may be the circumstance for instance if [redacted] and [redacted] were unable to sell the assets but for the payment of the IPO fees. Or the fees may have been part of the sales price. For instance, the sales price may have been reduced by the $[redacted] expended by [redacted] because the REIT needed but did not have the cash for the IPO which it was going to use to fund the sale. To the extent however that the payments were part of a corporate reorganization or restructuring of [redacted] to raise capital or for a future benefit, then the expenses must be capitalized.[1] In this regard, the Form 10-K places heavy emphasis on the relationship with the REIT as a funding source and indeed, the REIT exercised options after the initial sale to purchase four additional [redacted] facilities.

Case law analysis:

Although there is no case law on or near point, existing case law does provide some insight into how a court may resolve this issue.

In Pope & Talbot Inc. v. Commissioner, T.C. Memo. 1997-116, the court allowed as deductions, expenses incurred as legal, accounting, investment banking and other fees relating to the formation of a partnership, the transfer of assets to that partnership and the distribution of the partnership units to its shareholders. These transactions were consummated to spin off corporate assets to a new flow-through entity with favorable tax consequences. The court surmised that since costs connected with the sale of a capital asset were capital expenditures to be used to offset against the sales price, expenses incurred in a corporate

[1] We do not believe that it is important that [redacted] paid for the REITs expenses except for in the context discussed. Although expenses incurred for the benefit of another taxpayer are not deductible under I.R.C. § 162, under unique circumstances, a deduction will be allowed where a taxpayer for its own benefit pays the expense of another. Young & Rubicam, Inc. v. Commissioner, 410 F.2d 1233 (U.S. Ct Claims 1969) (direct benefit to taxpayer required for payments for another taxpayer to be deductible); Columbia Rope Company, 42 T.C. 800 (1964) (payments made to aid subsidiary to obtain services of needed management personnel not deductible by parent since payments not construed as taxpayer's own business expense). To the extent that the court finds that these were proper selling expenses, then a fortiori, they were for the benefit of [redacted].

distribution which was treated as a taxable sale under I.R.C. § 311(d)(1) was entitled to like treatment. The court did not discuss the fact that the expenses were not directly related to the distribution, but were incurred to create a separate entity to effectuate the transfer. Rather, the court merely stated, without additional authority, that it could "... see no reason why transaction costs should be treated differently in a deemed sale than are in an actual sale." The court ultimately concluded that the overall purpose of the activities was to distribute the properties.[2]

In FMR Corp. v.Commissioner, 110 T.C. No. 30 (1998), the court relying on INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992), held that expenditures to launch 82 regulated investment companies (RIC) were not deductible since the RICs created separate and distinct assets (the right to manage and market the new funds) which produced a significant future benefit.[3] The court found that the expenditures were capital and amortizable over its useful lives. The court found as instructive the fact that the expenditures were similar to organization costs, that is, those in connection with organizing, recapitalizing or merging a business, which are generally considered capital expenditures and not currently deductible. See also Rodeway Inns of America v. Commissioner, 63 T.C. 414 (1974) (payment to cancel franchise agreement capital expenditure since business opportunities enhanced; payment not merely related to current income production).[4]

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[2] The result in Pope & Talbot suggests that the Internal Revenue Service may need to establish to the court a reason why these types of expenses should not be treated the same as other sales expenses such as commissions or closing costs. In this regard, as explained later, the key may be the fair market value of the assets sold and the fair rental value of the assets leased to see if the IPO fees were disguised. Another alternative is the creation of the future benefits secured from the REIT in the form of a funding source and a leasing source. See Footnote 4.

[3] Although INDOPCO resolved perceived conflicts in the lower courts and held that the creation of a separate and distinct asset was not required for an expenditure to be capital, the creation of a separate and distinct asset will per se require capitalization.

[4] Pope & Talbot and FMR Corp. can be partially reconciled to the extent that no relationship and therefore no benefit existed for the transferor in Pope & Talbot after the asset distribution.

To the extent that the IPO fees were in connection with a corporate reorganization or other change in the corporate structure, then they are capital. INDOPCO, Inc. v. Commissioner, supra; Bilar Tool & Die Corp. v. Commissioner, 530 F.2d 708 (6th Cir. 1976). Moreover, expenses incident to raising capital in general are nondeductible capital outlays. McCrory Corp. v. United States, 651 F.2d 828 (2d Cir. 1981) and cases cited therein.

In McCrory Corp. v. United States, supra, the court on different facts was confronted with similar issues presented here:

McCrory Corp.	[redacted]
Whether the expenses were incident to corporate reorganization or to the purchase of assets?	Whether the expenses were incident to corporate reorganization, acquiring a long-term asset or benefit or to the sale of assets?
Whether all or part of the acquisition costs were deductible when expended in two acquisitions which were mixed transactions involving raising capital and purchasing assets?	Whether the IPO fees were incurred to raise capital by creating a funding source for the sale of assets or were a sales expense or both and if both, how should they be allocated?

The McCrory court was faced with the situation not unlike that here where through simultaneous transactions they raised capital and purchased assets through a tax-free stock exchange. The transactions in this case involved a corporate reorganization ([redacted] transfers assets to [redacted] in an I.R.C. § 351 transaction with an ultimate view toward sales to REIT), which also raised capital or at least changed the capital structure through the sale of assets (that is, what was once capital was now debt). The portion of the expenses in McCrory attributable to the asset purchases were deductible only when the assets were sold or liquidated. Those attributable to raising capital were not deductible at any time.[5]

You may want to analyze [redacted]'s debt and equity structures both prior and subsequent to the I.R.C. § 351 transactions and sale to the REIT to see how the transactions actually affected its capital structure.

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[5] See also Lykes Energy, Inc. v. Commissioner, T.C. Memo. 1999-77 and cases cited therein (selling expenses related to leased appliances must be capitalized. Selling expenses related to appliance sales were deductible).

Creation of future benefits:

To the extent that the payment of the IPO costs by [redacted] created a future benefit to [redacted], then the expenses will be capital. INDOPCO, Inc. v. Commissioner, supra; A.E. Staley Manufacturing Co. v. Commissioner, 119 F.2d 482 (7th Cir. 1997). The circuit court reversed the Tax Court in A.E. Staley Manufacturing Co. v. Commissioner, supra, and allowed the expenses to be deducted since: (1) they were incurred to prevent a merger; (2) there was no benefit, future or otherwise, to the merger for the transferor; and (3) the expenditures were not incurred to facilitate a change in corporate structure, but to prevent one.

In this case, [redacted] transferred assets to a subsidiary ([redacted]) for stock. The subsidiary sold the assets to the REIT for cash. Where [redacted] once had assets, it now had cash and long-term leases for these same assets. The Form 10-K underscored the relationship between [redacted] and the REIT and that it was expected to provide access to additional capital to fund future growth. The transactions between [redacted] and the REIT appear to have provided [redacted] with a long-term benefit sufficient to require capitalization. We suggest that you review the [redacted] business plan and director's minutes to determine the perceived benefit from the sale-lease back. We also suggest that you analyze [redacted]s before and after balance sheet to determine the changes in financial position. You may also want to analyze the effect that these transactions had on [redacted]s stock prices during this period. We also suggest that you review the [redacted] and [redacted] certified audit papers to see how the independent auditors disclosed and characterized the transaction between [redacted] and the REIT.[6] See Lykes Energy, Inc. v. Commissioner, supra, where the court found that promotional or selling expenses had to be capitalized where they were unrelated to a specific sale and intended primarily to increase its customer base which yielded a future benefit (that is, projected revenue stream) that was more than incidental.

The [redacted] transactions with the REIT may also have been part of a series of transactions to effectuate the reorganization whereby the REIT later purchased [redacted] for $[redacted]. In that instance, the facts may be directly controlled by INDOPCO, Inc. v. Commissioner, supra such that capitalization is required. We suggest that you determine if the [redacted] sale to the REIT was part of a series of steps concluding in the REIT purchasing [redacted] such that the step

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[6] We are not suggesting that you secure the tax accrual workpapers at this time. Should you decide to do so, we suggest that you review IRM 4024.4, which describes the requirements for seeking tax accrual workpapers.

steps. In this regard, we suggest that you first review the business plan, [redacted] director minutes and the IPO prospectus (and other public documents which disclosed the reason for the IPO) to see the stated objectives for the transactions.

Prepaid rental fees

The IPO fees may have been analogous to "points", that is, the payment of the IPO fees may have been prepaid rent, intended either to increase the rental payments to the REIT or to provide them with up-front cash to fund the IPO. While the Form 10-K indicates that the leases were at fair market value, since related parties were involved, the leases may have been at below market value, the prepayment through the IPO fees bringing the lease to a fair market rate. In that event, the IPO fees would only be deductible ratably over the term of the relationship between [redacted] and the REIT, measured by the useful lives of the assets purchased, the lease terms or some other term indicative of their relationship. Baird v. Commissioner, 68 T.C. 115 (1977); Lay v. Commissioner, 69 T.C. 421 (1977). See also Rodeway Inns of America v. Commissioner, supra and authorities cited therein, where the court found that the cost of acquiring an intangible asset can be amortized if it has a useful life which can be estimated with reasonable accuracy.

Factual development:

We suggest factual development to determine why [redacted] paid the IPO fees for the REIT. The first step is to examine the contracts, agreements and invoices for the IPO fees. A review of these documents is necessary to determine the nature of the work that was performed and whether it was related to the sale (such as a determination of the fair market value of the assets that were sold) or to the IPO. If related to the IPO, it is necessary to determine why [redacted] paid these expenses. Interestingly, the payment of the IPO fees was not disclosed in the Form 10-K although other aspects of the relationship between [redacted] and the REIT was.[7] Other necessary factual determinations include the legal relationship between [redacted] and the REIT and how the legal obligation to pay the IPO fees by [redacted] arose (that is, was it a term of the sales and/or lease agreements) and why (that is, was the reason for payment of the IPO fees disclosed in the business plan, board of director minutes or sales and/or lease agreements).

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[7] In order to fully understand the relationship between [redacted] and the REIT, you may want to determine the purpose of the Form S-3 and why [redacted] was required to be a co-registrant for the IPO and preferred stock issuance. This inquiry may also be relevant to the [redacted] recapitalization issue.

Another inquiry that you may want to make concerns the manner in which the sales price and lease rates for the prisons were determined.[8] The objective is to determine if the IPO fees were a disguised portion of the sales price, that is, was the sales price increased by the amount of the IPO fees to facilitate the sale. In that instance, it seems clear that the IPO fees should be allowed to reduce the amount realized since the payments offset the increase to the sales price. Or as earlier discussed, the payment may have been prepaid rent in order for [redacted] to accelerate the deduction.

We also suggest that you confirm the form of the transaction by reviewing the transactional documents. The Form 10-K indicates that as of [redacted], [redacted] had been sold to the REIT for $[redacted]. You should determine that the funds were transferred and how. You should also determine how the sales were treated on the [redacted] books and records. You should also determine how the IPO fees were treated on the income tax returns and for financial reporting purposes. If they were simply expensed and not used to reduce the amount realized from the sale, then an inference could be drawn that they were not related to the sale and that these attempts to do so now were merely attempts to recharacterize the transaction.

The timing of the transactions and ultimate plan should also be determined. To the extent that the step transaction doctrine applies and it was contemplated at the time that the IPO was issued that [redacted] and the REIT would further reorganize, then this could support the argument that the IPO fees were to raise capital, the first step in a reorganization or recapitalization or as a capital contribution in the REIT. Therefore, we suggest that you review the business plans for the formation and capitalization of the REIT, the asset sales to it by [redacted], and the ultimate purchase of [redacted] by the REIT to see if they were integrated transactions.

[8] This raises collateral issues that you may want to consider. [redacted] and the REIT were at least related through a common board chairman, and you may want to determine the extent of the common relationship. Issues that may be present include whether the sales prices was in excess of fair market value in order to increase the basis and depreciation deductions for the REIT, and whether the leases were in excess of fair rental value to transfer excess funds from [redacted] to the REIT. Since the REIT in general operates as a conduit, the taxpayers may have been attempting to avoid double taxation. Depending on the relationship, an I.R.C. §§ 162 or 482 adjustment may be warranted. You would need to develop and understand the ownership structure of the REIT and the extent to which common control existed in order for I.R.C. § 482 to apply.

Please contact the undersigned at 250-5072 if you have any questions. Attached is a client survey which we request that you consider completing. The client survey is an attempt to measure your satisfaction with the service provided by this office. We expect to be able to use your response to improve the services that we provide to you. Our file remains open to assist you further with the factual development and legal analyses involved with the IPO fee issue.

JAMES E. KEETON, JR.
District Counsel

By: ______________________
HOWARD P. LEVINE
Senior Attorney

cc: Don Williamson (ARC-LC) (via e-mail)